Petition

Office-Supreme Court, U.S.
FILED
AUG 7 1981
ALEXANDER L. STEVAS, CLERK

81-278
No. 81-

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

PACIFIC POWER & LIGHT COMPANY,

Petitioner

v.

UNITED STATES OF AMERICA,

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED

Whether a taxpayer that uses its own equipment in self-constructing long-lived assets may currently deduct for federal income tax purposes the difference between its tax depreciation allowance with respect to such equipment, computed using allowable accelerated methods of depreciation, and its book depreciation allowance with respect to such equipment, where (a) the taxpayer uses such equipment for both construction and operations and (b) its book depreciation allowance, which is mandated by those regulatory authorities having jurisdiction over it, most accurately allocates the cost of using such equipment to the periods benefited by its use.

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Petitioner, Pacific Power & Light Company,[1] respectfully prays that a writ of certiorari issue to review the

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1. Petitioner has no parent companies or affiliates. Except for wholly owned subsidiaries, the following are all of its subsidiaries: Telephone Utilities, Inc.; Creswell Telephone Company; Gem State Utilities Corporation; Northwestern Telephone Systems, Inc.; Westana Corporation; Northwest Energy Services Company; and Pacific Northwest Power Company.

judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on May 11, 1981.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 664 F.2d 1358, 81-1 U.S. Tax Cas. (CCH) ¶ 9430, and 47 AFTR2d 1531, and set forth in Appendix A to this petition. The District Court issued no opinion other than its Findings of Fact and Conclusions of Law, set forth in Appendix B to this petition, which Findings and Conclusions were not published.

JURISDICTION

The judgment of the Court of Appeals was entered on May 11, 1981. No petition was filed for rehearing or rehearing en banc. This petition for certiorari was filed within 90 days of the entry of the judgment of the Court of Appeals. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED

This case involves Sections 167, 263, 451, 471, and 1012 of the Internal Revenue Code of 1954, as amended (the "Code"), Title 26, United States Code, relevant portions of which are set forth in Appendix D to this petition.

REGULATIONS INVOLVED

This case involves Sections 1.263(a)-2, 1.451-3(d)(5), and 1.471-11(c)(2) of the Income Tax Regulations of the Department of the Treasury ("Treas. Reg."), Title 26, Code of Federal Regulations, relevant portions of which are set forth in Appendix E to this petition.

STATEMENT OF THE CASE

This civil action was brought against the United States of America for the recovery of income tax and interest totaling $225,954.74, together with statutory interest thereon. Jurisdiction in

the District Court was based on 28 U.S.C. § 1346(a)(1).

Plaintiff and petitioner, Pacific Power & Light Company ("Pacific"), is a Maine corporation engaged in the generation, transmission and distribution of electricity in Oregon, Washington, Wyoming, Montana, California and Idaho. During the years at issue, 1962-1966, Pacific was regulated by the Federal Power Commission (now the Federal Energy Regulatory Commission ("FERC")) and the public utility commissions of these six states (R.21, Agreed Facts, ¶¶ 13 and 14, pp. 6-8). During these years, Pacific continually engaged in constructing new transmission and distribution facilities to meet the increasing demand for electric energy in its service area. In constructing these assets, Pacific used various pieces of its own transportation equipment (including autos, light trucks, heavy

trucks and trailers) and power-operated equipment. Pacific also used this equipment in operations and maintenance (R.21, Agreed Facts, ¶ 2, pp. 2-3, ¶ 6, p. 4 and ¶ 12, p. 5).

For purposes of preparing the financial reports filed with the regulatory authorities having jurisdiction over it, as well as its financial reports to the Securities and Exchange Commission, Pacific complied with the Uniform System of Accounts (R.21, Agreed Facts, ¶¶ 13, 14 and 15, pp. 6-8). In accordance with the Uniform System of Accounts mandated by FERC (R.21, Agreed Facts, ¶ 13, p. 6), Pacific computed its book depreciation using the straight-line method, and useful lives and salvage values determined in depreciation studies periodically conducted by independent consultants (R.21, Agreed Facts, ¶¶ 8, 13, 17 and 18, pp. 5-10). Pacific's own statistics indicate

that its use of the straight-line method accurately portrays the actual pattern of usage of the transportation and power-operated equipment that it uses in construction and operations (R.21, Ex. 7).

For federal income tax purposes, Pacific elected to compute depreciation by use of the more accelerated, double declining balance method (R.21, Agreed Facts, ¶¶ 8 and 9, p. 5). During the years in issue, in calculating its tax depreciation allowance, Pacific also utilized the guideline useful lives permitted under the class life system then in effect (R.21, Agreed Facts, ¶ 19, p. 10). These lives were shorter than those used for book purposes, which were based on Pacific's actual depreciation studies (R.21, Agreed Facts, ¶ 17, p. 9 and ¶ 19, p. 10).

In accordance with the Uniform System of Accounts, for book purposes

Pacific capitalized as part of the cost of its self-constructed assets an allocable portion of the book depreciation sustained in respect of the transportation and power equipment that it used in construction. In its 1962-1966 federal income tax returns, however, Pacific capitalized no construction-related depreciation for tax purposes. Upon audit of Pacific's returns for those years, respondent required correction of the returns with respect to the issue of capitalized depreciation, and on December 29, 1967, assessed Pacific additional income taxes. Pacific made full payment of these assessments under protest on January 15, 1968. Subsequently, Pacific filed timely claims for refund, based in part on the issue raised in this case (R.21, Agreed Facts, ¶¶ 3, 4 and 5, pp. 3-4).

Respondent delayed ruling on Pacific's refund claims pending this Court's decision in Commissioner v. Idaho Power Company, 418 U.S. 1 (1974), and thereafter disallowed Pacific's refund claims. Pacific filed its complaint[2] in this case on November 3, 1977 (R.21, Agreed Facts, ¶ 5, pp. 3-4), contending that Idaho Power required that construction-related depreciation be capitalized only if and to the extent it constituted a cost incurred. Because Pacific's book depreciation is based on actual empirical studies and made mandatory by the regulatory agencies having jurisdiction over it, it truly reflects Pacific's cost of using its construction-related equipment. Accordingly, Pacific

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2. There are no parties to this case other than petitioner and respondent named in the caption of the case in this petition. Rule 21.1(b) of this Court.

argued that to require taxpayers to capitalize their entire tax depreciation allowance with respect to such equipment, where such allowance clearly was in excess of its cost depreciation, would violate the rationale of Idaho Power and the language of Sections 263 and 1012 of the Code, and thwart the Congressional intent that accelerated depreciation allowances spur investment in the ecomony.

The action was tried without a jury on May 23, 1979 on the stipulated facts set forth in the pretrial order, as supplemented. On May 25, 1979, the District Court, the Honorable Manuel L. Real, issued its Findings of Fact and Conclusions of Law and entered a Judgment of Dismissal against Pacific.

Pacific appealed the decision to the United States Court of Appeals for the Ninth Circuit, in which the case was argued and submitted on March 5, 1981.

On May 11, 1981, the Court of Appeals affirmed the decision of the District Court. The judgment of the Court of Appeals is set forth in Appendix C attached to this petition.

REASONS FOR GRANTING THE WRIT

I. This Court's Decision in Commissioner v. Idaho Power Company Left Unanswered a Crucial Question on Which Lower Courts Need Guidance.

In Commissioner v. Idaho Power Company, supra, this Court held that depreciation on equipment used in constructing one's own assets must be capitalized as part of the cost of the constructed assets. The Court did not, however, consider what measure of depreciation should be used in this capitalization process, as the parties had stipulated the amount of depreciation to be capitalized if the government prevailed. Thus, the protagonists in Idaho Power focused only on

whether any construction-related depreciation was required to be capitalized for tax purposes. As a result, this Court's opinion in Idaho Power did not address whether all tax depreciation allowable with respect to assets used in self-constructing capital improvements must be capitalized, even where such tax depreciation allowance exceeds cost or economic depreciation.

Congressional policy, embodied in the Code, clearly favors acceleration of cost recovery (through the allowance for depreciation) for assets such as construction equipment, in order to stimulate investment in such equipment. E.g., S. Rep. to H.R. 3000, 83d Cong., 2d Sess., reprinted in [1954] U.S. Code Cong. & Ad. News 4621, 4655-59. As Idaho Power illustrated, however, the tax laws also demand that capital expenditures, including

depreciation to the extent it constitutes a cost incurred, be included in the basis of the assets with respect to which they are incurred, so that expenses will be properly matched with revenues. This Court in Idaho Power did not delineate the degree to which these two fundamental tax principles conflict, as the taxpayer did not contest how much depreciation should be capitalized if respondent prevailed.

Notwithstanding this, the lower courts' decisions in the instant case reveal that such courts incorrectly believe this Court did in fact consider this issue. The courts below incorrectly perceive that this Court resolved the question by holding that all construction-related tax depreciation, whether or not it accurately allocates the cost of using the equipment to the periods benefited

thereby, must be capitalized.[3] Their error illustrates that the lower courts require guidance on the precise holding of this Court in Idaho Power. Otherwise, based on a mistaken reading of that precedent, an important Congressional policy will be thwarted, and fundamental tax accounting principles and important provisions of the Code will be violated.[4]

II. The Decisions of the Courts Below in the Instant Case Conflict With

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3. While the Ninth Circuit clearly believed Idaho Power was dispositive of this issue, its opinion in the instant case inconsistently acknowledged that the case presented a "novel question." See Appendix A, Page 1.

4. The Ninth Circuit's opinion in the instant case inaccurately implies that Pacific's principal argument is that respondent's position offends Congressional intent. While this policy argument is an important one, Pacific's principal argument, as set forth in its briefs filed with the Ninth Circuit, is that respondent's position is in contravention of the Code and inconsistent with the rationale of Idaho Power.

Principles Enunciated by This Court in Idaho Power, and With Provisions of the Code.

In Idaho Power this Court analyzed the purpose of depreciation and concluded that its function was to allocate the cost of using capital assets (that is, assets having useful lives in excess of one year) to the periods benefited by such use, thereby matching expense with revenue. 418 U.S. at 10-11.

This Court then analyzed the purpose of Section 263 of the Code to determine whether it was in conflict with this concept of depreciation, and whether it imposed different requirements on taxpayers:

> "The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years

> when the capital asset becomes income producing. The regulations state that the capital expenditures to which § 263(a) extends include the 'cost of acquisition, construction or erection of buildings.' Treas. Reg. § 1.263(a)-2(a). This manifests an administrative understanding that for purposes of § 263(a)(1), 'amount paid out' equates with 'cost incurred.'" 418 U.S. at 16 (emphasis supplied).

The essence of the Court's decision in Idaho Power, then, is that construction-related depreciation, to the extent it constitutes a cost incurred, must be capitalized to properly match income and expense as required by fundamental tax accounting principles. Such depreciation must also be capitalized under Section 263(a)(1) of the Code, which requires that "amounts paid out" in connection with the construction of permanent improvements be capitalized.

This holding is not, however, the same as holding that a taxpayer's

entire construction-related depreciation allowance under Section 167 of the Code must be capitalized. Such a rule would be particularly inappropriate where the taxpayer can demonstrate that its tax depreciation exceeds its cost depreciation, which is most accurately measured by its book depreciation, and where book depreciation is derived from actual empirical studies of the taxpayer's equipment and made mandatory by regulatory agencies having jurisdiction over it.[5]

To the contrary, to read Idaho Power as the lower courts have done in

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5. In Idaho Power, this Court declared that "where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency and that method clearly reflects income, it is almost presumptive controlling of federal income tax consequences." 418 U.S. at 15 (emphasis original; footnote omitted). Pacific's regulatory agencies have required it to capitalize that portion of its book depreciation allocable to construction (R.21, Agreed Facts, ¶¶ 12-14, pp. 5-8).

this case subverts the rationale underlying this Court's decision, and contravenes Sections 263 and 1012 of the Code. To illustrate this, consider as an example a truck with an economic useful life of 15 years (R.21, Agreed Facts, ¶ 18, p. 10), but whose cost generally can be depreciated for tax purposes using the double declining balance method over a useful life of five years. (See Section 167(b)(2) of the Code; Rev. Proc. 77-10, 1977-1 C.B. 548, 550.) In the first year of its life, the truck is used by its owner solely in connection with the construction of such owner's longer-lived transmission lines. In the latter 14 years of the truck's life, the taxpayer uses the truck solely for operation and maintenance purposes.

If all of the first-year tax depreciation allowance with respect to the truck must be capitalized, 40 percent of

its cost must be capitalized into the cost of the transmission line, when in fact only 6.67 percent of the truck's true cost was actually assimilated into the cost of the constructed transmission line (R.21, Ex. 7). By capitalizing depreciation which is not "an amount paid out," this practice not only violates Section 263 of the Code, but also overstates the cost basis of the transmission lines in contravention of Section 1012 of the Code. In addition, it significantly understates depreciation expense attributable to operation and maintenance over the remaining 14 years of the truck's life.

Pacific does not question that construction-related depreciation must be capitalized to the extent it represents a cost incurred; that in accordance with the priorities set by Code Sections 161 and 261, Section 263(a)(1) takes precedence

over Section 167 to the extent they conflict; and that a taxpayer will eventually be entitled to the same amount of depreciation, no matter which depreciation method, useful life or capitalization rule applies. The only issue in this case is the timing of Pacific's depreciation deductions - that is, whether tax depreciation or book depreciation should be capitalized to achieve what respondent itself has conceded is the underlying objective of depreciation and tax accounting: "to distribute this [depreciation] cost over the accounting periods benefited by the use of the asset, thereby matching income and expense. 418 U.S., pp. 10-11." Appellee's Brief to the Court of Appeals, page 13.

Pacific contends that its tax depreciation allowance with respect to its construction equipment should be bifurcated - that it should capitalize

cost depreciation as measured by its book depreciation, and deduct the excess tax allowance as a current period expense. This is not some radical ad hoc suggestion that will impose an undue burden on respondent solely to benefit a single taxpayer. Rather, it is exactly the solution devised by respondent in its Treasury Regulations governing directly analogous situations: the allocation of depreciation with respect to equipment used to manufacture inventory or to perform long-term construction contracts. Treas. Reg. § 1.471-11(c)(2) and § 1.451-3(d)(5), respectively. Pursuant to these legislative regulations, adopted under authority granted in Sections 451 and 471 of the Code, the taxpayer is required to allocate to its self-manufactured inventory or long-term construction contract only its book depreciation; it is permitted to deduct

any excess tax depreciation as a current expense. Thus, Pacific's view emanates from respondent's own regulations in analogous circumstances, and produces the only result which adheres to the dictates of the Code, Idaho Power and clear Congressional policy.

III. This Case Raises an Important Tax Issue, Likely to Recur in Litigation, Affecting Many Taxpayers and Substantial Amounts of Tax Liability.

The significance of this case transcends the calculation of Pacific's tax liability. It affects directly all taxpayers who self-construct capital assets, and indirectly those taxpayers who use their own assets to perform services and manufacture goods. If the decisions below are not reversed, these taxpayers (and ultimately their customers) stand to pay larger taxes than they should, and

they are thereby deprived of important resources that they otherwise could reinvest to strengthen our economy.

At stake is whether Congressional intent in providing liberalized depreciation will be frustrated by expanding the scope of Section 263 of the Code beyond its clear limits. Because the decisions below mismatch expenses with revenues, and cause self-constructed assets to have bases in excess of their cost, they will, if not reversed, do great violence to basic tax accounting principles embodied in the Code, and undermine overall confidence in, and the integrity of, our federal tax system.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the

judgment and opinion of the Court of Appeals for the Ninth Circuit.

Respectfully submitted,

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William J. Glasgow,
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Petitioner

APPENDIX A

OPINION OF COURT OF APPEALS

PACIFIC POWER & LIGHT COMPANY,
a Maine corporation,
Plaintiff-Appellant,

v.

UNITED STATES of America,
Defendant-Appellee.

No. 79-4455.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted March 5, 1981.

Decided May 11, 1981.

On Appeal from the United States District Court for the District of Oregon.

Before ANDERSON, PREGERSON, and CANBY, Circuit Judges.

PREGERSON, Circuit Judge:

This federal income tax case presents the novel question whether section 167(a) of the Internal Revenue Code of 1954 (I.R.C.)[1] authorizes a taxpayer

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1. I.R.C. § 167(a) DEPRECIATION.

(a) GENERAL RULE--There shall be allowed as a depreciation deduction a

to deduct from gross income the difference between accelerated and straight-line depreciation of equipment owned by taxpayer and used by it to construct its own capital facilities, or whether the capitalization provision of I.R.C. § 263(a)(1)[2]

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reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--

(1) of property used in the trade or business, or

(2) of property held for the production of income.

2. I.R.C. § 263. CAPITAL EXPENDITURES.

(a) GENERAL RULE--No deduction shall be allowed for--

1. Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate ....

The Treasury Regulation interpreting I.R.C. § 263(a)(1) states in relevant part:

§ 1.263(a)-2--Examples of capital expenditures.

The following paragraphs include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and

prohibits the deduction. We affirm the district court's holding, premised on Commissioner v. Idaho Power Co., 418 U.S. 1, 94 S.Ct. 2757, 41 L.Ed.2d 535 (1974) (Idaho Power), that where any depreciation of equipment attributable to construction of taxpayer's facilities must be capitalized under I.R.C. § 263(a)(1), no part of such depreciation may be deducted from gross income under I.R.C. § 167(a).

The parties stipulated to the following relevant facts. Pacific Power & Light Company (Pacific Power), a public utility incorporated in Maine, is engaged in the business of generating, transmitting, distributing, and selling electricity in Oregon, Wyoming, Washington, California, Montana, and Idaho.

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equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

During the years in issue, 1962 through 1966, Pacific Power constructed for its own use new power transmission and distribution facilities to supply electrical energy in its service area. In constructing these capital assets, Pacific Power used its own transportation vehicles and power equipment.

For general accounting purposes, Pacific Power depreciated the vehicles and equipment employed in constructing the new facilities by using the straight-line method. The useful lives and salvage values of the vehicles and equipment were determined by independent consultants. On its books, Pacific Power allocated the depreciation of its vehicles and equipment to the overall cost of such new facilities.[3]

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3. These accounting methods were required by the state and federal regulatory agencies with jurisdiction over

For federal income tax purposes, however, Pacific Power treated the depreciation of the transportation and power equipment differently. In computing its federal tax liability, Pacific Power used the double-declining balance depreciation method,[4] and determined the useful lives of the vehicles and equipment under the class-life system.[5] Pacific Power, in its income tax returns for the taxable

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Pacific Power. During the years in issue, 1962 through 1966, Pacific was regulated by the Federal Power Commission (now the Federal Energy Regulatory Commission) and six state public utility commissions.

4. I.R.C. § 167(b)(2) permits a taxpayer to use a rate of depreciation not greater than twice the rate under the straight-line method. This method is referred to as double-declining balance.

5. I.R.C. § 167(m) authorizes the Commissioner to establish useful lives for classes of property in a particular industry or group. A taxpayer is allowed to compute the depreciation deduction based on these class lives rather than having to compute the useful life of any particular asset.

years 1962 through 1966, deducted from gross income the total accelerated depreciation attributable to the transportation and power equipment, which deduction included the depreciation attributable to the equipments' use in constructing Pacific Power's capital facilities. The Internal Revenue Service assessed tax deficiencies on the ground that the depreciation of the transportation and power equipment used to construct such new facilities should have been capitalized under I.R.C. § 263(a)(1). Pacific Power paid the assessment under protest and subsequently filed this action against the government to recover payment of tax assessments totaling $225,954.74. The United States District Court for the District of Oregon on May 25, 1979 entered final judgment dismissing Pacific Power's complaint and taxpayer appeals. We have jurisdiction under 28 U.S.C. § 1291.

In Idaho Power, which we believe controls the disposition of this case, the Court held that "the equipment depreciation allocable to taxpayer's construction of [its own] capital facilities is to be capitalized." 418 U.S. at 19, 94 S.Ct. at 2767. In reaching this conclusion the Court explained that:

> the exhaustion of construction equipment does not represent the final disposition of the taxpayer's investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. Construction-related depreciation on the equipment is not an expense to the taxpayer of its day-to-day business. It is, however, appropriately recognized as a part of the taxpayer's cost or investment in the capital asset.

418 U.S. at 13-14, 94 S.Ct. at 2764-2765.

In Idaho Power, the Court considered the interrelationship between I.R.C. §§ 263, 161, 261, and 167, which also apply to this case. I.R.C. § 263(a)(1) disallows deductions for

"[a]ny amount paid out" by a taxpayer for construction or permanent improvement of its facilities.[6] As the Court pointed out:

> The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing.

418 U.S. at 16, 94 S.Ct. at 2766. Although I.R.C.§ 167(a) allows a depreciation deduction for "exhaustion, wear and tear" of property used in the taxpayer's trade or business, the Court interpreted I.R.C. § 161[7] and

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6. See footnote 2 supra.

7. I.R.C. § 161 provides:

ALLOWANCE OF DEDUCTIONS.
In computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part, subject to the exceptions

§ 261[8] to require that § 263(a) take precedence over § 167(a). Thus, "an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under [§ 167(a)]." 418 U.S. at 17, 94 S.Ct. at 2766.

Finally, the Court in Idaho Power voiced its concern for maintaining tax-parity. A taxpayer who pays an independent contractor to construct a capital facility would have to capitalize all of the construction-related depreciation costs charged to it by the contractor.

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provided in part IX (sec. 261 and following, relating to items not deductible). (Emphasis added.)

8. I.R.C. § 261 provides:

GENERAL RULE FOR DISALLOWANCE OF DEDUCTIONS.

In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

The Court thus concluded that the same complete capitalization should result when a taxpayer builds its own capital facilities--i.e., that there should be no tax advantage for such self-construction. 418 U.S. at 14, 94 S.Ct. at 2765.

Before the Court's decision in Idaho Power, Pacific Power, in its federal income tax returns, claimed a depreciation deduction for the full amount of accelerated depreciation of its transportation and power equipment used to construct its own capital facilities. Thus, for federal tax purposes, Pacific Power did not capitalize any of such depreciation. Its pre-Idaho Power stance was therefore identical to the position explicitly rejected by the Court in that case.

In the instant suit, Pacific Power assumes the following fall-back position. It asserts that to give effect

to Congress's policy to encourage investment in depreciable assets by providing an accelerated depreciation deduction, a taxpayer using its own equipment to construct its own capital facilities should be permitted to deduct from gross income the difference between accelerated and straight-line depreciation. Pacific Power contends that in Idaho Power the Court did not consider what measure of depreciation should be used when capitalizing depreciation for purposes of I.R.C. § 263(a)(1). Accordingly, Pacific Power argues that the rule of Idaho Power is met by allocating to the construction costs of capital facilities a sum representing straight-line depreciation of the equipment used. Pacific Power uses this method for general accounting purposes and argues that it reflects the actual costs incurred in connection with construction of its capital facilities. In short, taxpayer argues

that, to further congressional policy, it should be entitled to deduct from gross income the difference between straight-line and double-declining balance depreciation. To adopt Pacific Power's position would result in bifurcating the depreciation of equipment used by taxpayers to construct their own capital facilities: straight-line depreciation would be capitalized and deducted over the life of the capital facility constructed, whereas the excess of double-declining balance over straight-line depreciation would be deducted as a current business expense under I.R.C. § 167(a).

The government asserts that Idaho Power, where taxpayer computed depreciation under both the straight-line and declining balance methods, 418 U.S. at 5, 94 S.Ct. at 2760, controls the disposition of this case. We agree.

Although Pacific Power presents an ingenious argument, one best presented to Congress, we find the reasoning and reach of Idaho Power to be dispositive of taxpayer's contentions. As the Court stated in Idaho Power:

> To be sure, the 1954 Code provided for new and accelerated methods for depreciation, resulting in the greater depreciation deductions currently available. These changes, however, relate primarily to computation of depreciation. Congress certainly did not intend that provisions for accelerated depreciation should be construed as enlarging the class of depreciable assets to which § 167(a) has application or as lessening the reach of § 263(a). See Note 1973 Duke L.J. 1386.

418 U.S. at 18-19, 94 S.Ct. at 2767.

We hold that where any equipment depreciation must be capitalized under I.R.C. § 263(a)(1), no part of such depreciation may be deducted under I.R.C. § 167(a).

The judgment of the district court is AFFIRMED.

APPENDIX B

FINDINGS AND CONCLUSIONS
BY DISTRICT COURT

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

PACIFIC POWER & LIGHT COMPANY,
a Maine corporation,
Plaintiff,

v.

UNITED STATES OF AMERICA,
Defendant.

CIVIL NO. 77-892

FINDINGS OF FACT, CONCLUSIONS
OF LAW, AND ORDER

This action having been tried before the Court, pursuant to Rule 52 of the Federal Rules of Civil Procedure, the following Findings of Fact and Conclusions of Law are made:

FINDINGS OF FACT

1. Plaintiff Pacific Power & Light Company is a Maine corporation engaged in the production and distribution of electricity in Oregon, Wyoming, California, Montana, and Idaho.

2. During the years 1962 through 1966 plaintiff was regulated by the Federal Power Commission and the state public utility commissions in the states where it operated.

3. During the years 1962 through 1966 plaintiff was continually engaged in the construction of new transmission and distribution facilities in order to supply the increasing demands for electric energy in its service area. In constructing these assets itself, it used various items of transportation and power equipment, including automobiles, trucks, trailers, and other miscellaneous equipment.

4. For genenal financial accounting purposes the plaintiff was required by the governing regulatory agencies to report and did in fact report depreciation expenses on its items of transportation and power equipment utilizing the straight-line method. The useful lives of the

equipment were determined by empirical studies performed by outside consultants reviewing plaintiff's own experience with its equipment.

5. For federal income tax purposes, the plaintiff elected to compute depreciation by the double-declining balance method. Plaintiff also elected for tax purposes to utilize the class life system allowed by the defendant.

6. On its federal corporate income tax returns filed for the years 1962 through 1966 plaintiff deducted the total accelerated depreciation computed for the transportation and power equipment, including that allocable to the equipment's use in self-construction of its transmission and distribution facilities.

7. Upon audit of the federal corporate income tax returns filed by the plaintiff for the years 1962 through 1966, the Internal Revenue Service on

December 29, 1967, assessed tax deficiencies on the basis that the accelerated depreciation claimed for tax purposes on the transportation and power equipment had to be capitalized to the extent of its use in the construction of the transmission and distribution facilities. Plaintiff made full payment of the tax assessments on January 16, 1968.

8. On May 15, 1969, the plaintiff timely filed claims for refund for the assessed additional taxes paid for 1962, 1963 and 1964. On October 7, 1969, plaintiff timely filed a claim for refund for the assessed additional taxes paid for 1965. On December 22, 1969, plaintiff timely filed a claim for refund for the assessed additional taxes paid for 1966.

9. The Internal Revenue Service delayed ruling on plaintiff's refund claims pending the Supreme Court's decision in Commissioner v. Idaho Power

Company, 418 U.S. 1 (1974) and thereafter disallowed the claims in full.

10. Plaintiff timely filed this action seeking a refund of $192,682.13, plus interest.

CONCLUSIONS OF LAW

1. This Court has jurisdiction over this action pursuant to 28 U.S.C. § 1346(a)(1).

2. This case presents a factual extension of the treatment of tax depreciation of equipment used in the self-construction of longer-lived capital assets addressed by the Supreme Court in Commissioner v. Idaho Power Company, 418 U.S. 1 (1974).

3. In Idaho Power, as in the case at bar, a regulated public utility used a variety of automotive transportation equipment, including passenger cars, trucks of all description, power-operated equipment, and trailers, to construct its

own transmission and distribution facilities. There, as here, the taxpayer and the Commissioner agreed to a mathematical allocation between the transportation equipment's use in such construction and in its ordinary business usage. The taxpayer in Idaho Power had argued that Section 167 of the Internal Revenue Code of 1954 (26 U.S.C.) permitted it to currently deduct for tax purposes all the claimed straight-line depreciation on the automotive equipment used in the self-construction.

4. The Supreme Court in Idaho Power denied any current depreciation deduction to the taxpayer under Section 167 and required that it capitalize such expenses into the cost of the longer lived, self-constructed capital assets pursuant to Section 263.

5. The Idaho Power Court held that the priority-ordering provisions of

Section 161 of the Code required that the capitalization provisions of Section 263(a) take precedence over the depreciation rules of Section 167(a). 418 U.S. at 17.

6. The case at bar is similar in all relevant respects except that the plaintiff here is only seeking to deduct currently for tax purposes the excess of accelerated depreciation over what amount would have been allowable if the book (straight-line) method of depreciation were used.

7. Plaintiff's asserted factual distinction is without merit. The mandate of the Idaho Power decision is that pursuant to Section 161 the computational rules of Section 167 are subordinate to the capitalization provisions of Section 263. See Revenue Ruling 77-325, 1977-2 Cum. Bull. 67.

8. The Court holds that all of the depreciation expenses claimed for tax purposes for equipment allocable to its use in the self-construction of longer-lived assets must be capitalized for tax purposes into the cost of the capital improvement regardless of the method of depreciation or useful life used for book purposes.

9. Plaintiff's complaint for the refund of federal income taxes shall be dismissed. Each party shall bear its own costs in this matter.

DATED this 25th day of May, 1979.

s/ MANUEL L. REAL
MANUEL L. REAL
United States District Judge

Prepared by
Gerald A. Kafka
Trial Attorney, Tax Division
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Washington, D.C. 20530
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Approved as to form:

s/ MARK H. PETERMAN

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APPENDIX C

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PACIFIC POWER & LIGHT COMPANY,
a Maine corporation,
Plaintiff-Appellant,

vs.

UNITED STATES of America,
Defendant-Appellee.

No. 79-4455.

DC CV 77-892 MLR

APPEAL from the United States District Court for the District of OREGON (Portland).

THIS CAUSE came on to be heard on the Transcript of the Record from the United States District Court for the District of OREGON (Portland) and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the judgment of the said

District Court in this Cause be, and hereby is affirmed.

Filed and entered May 11, 1981.

APPENDIX D

STATUTES INVOLVED

This case involves the following provisions of the Internal Revenue Code of 1954, as amended, Title 26, United States Code:

SEC. 167. DEPRECIATION

(a) General Rule.--There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolesence)--

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) Use of Certain Methods and Rates.--For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an

allowance computed in accordance with regulations prescribed by the Secretary, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances

which would have been used had such allowances been computed under the method described in paragraph (2). Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

* * * * *

SEC. 263. CAPITAL EXPENDITURES

(a) General Rule.--No deductions shall be allowed for--

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to--

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc., deductible under section 180,

(E) expenditures by farmers for clearing land deductible under section 182,

(F) expenditures for removal of architectural and transportation barriers to the handicapped and elderly which the taxpayer elects to deduct under section 190, or

(G) expenditures for tertiary injectants with respect to which a deduction is allowed under section 193.

* * * * *

SEC. 451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION

(a) General Rule.--The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

* * * * *

SEC. 471. GENERAL RULE FOR INVENTORIES

Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

* * * * *

SEC. 1012. BASIS OF PROPERTY--COST

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

APPENDIX E

REGULATIONS INVOLVED

This case involves the following provisions of the Income Tax Regulations of the Department of the Treasury, Title 26, Code of Federal Regulations:

§ 1.263(a)-2 Examples of capital expenditures.

The following paragraphs include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

* * * * *

§ 1.451-3 Long-term contracts.

* * * * *

(d) Completed contract method--

* * * * *

(5) In determining what costs are properly allocable to a long-term contract in the case of a taxpayer utilizing the completed contract method of accounting for tax purposes, the following rules shall apply:

* * * * *

(ii) The term "indirect costs" includes all costs (other than direct material costs and direct labor costs), which are incident to and necessary for the performance of particular long-term contracts. Indirect costs which must be allocated to long-term contracts include:

* * * * *

(j) Depreciation and amortization reported for financial purposes on equipment and facilities used in the performance

of particular long-term contracts * * *.

(iii) Costs which are not required to be included in costs attributable to a long-term contract include:

* * * * *

(i) Depreciation and amortization on idle equipment and facilities and depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports * * *.

§ 1.471-11 Inventories of manufacturers.--

* * * * *

(c) Certain indirect production costs--

(2) Includibility of certain indirect production costs--

* * * * *

(ii) Costs not included in inventoriable costs. Costs which are not required to be included for tax purposes in the computation of the amount of inventoriable costs (regardless of their treatment by a taxpayer in his finanical reports) include:

* * * * *

(i) Depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported by the taxpayer in his financial reports * * *.

Opposition

Office - Supreme Court, U.S.
FILED
SEP 15 1981
ALEXANDER L. STEVAS
CLERK

No. 81-278

In the Supreme Court of the United States

OCTOBER TERM, 1980

PACIFIC POWER & LIGHT COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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In the Supreme Court of the United States

OCTOBER TERM, 1980

No. 81-278

PACIFIC POWER & LIGHT COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

In this federal income tax case, petitioner seeks review of the decision below holding that all the depreciation expenses it claimed for 1962 - 1966 (including the excess of accelerated over straight-line depreciation) with respect to transportation and power equipment used in the construction of transmission and distribution facilities must be capitalized pursuant to Section 263 of the Internal Revenue Code of 1954, and this Court's decision in *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974).

The pertinent facts are undisputed and may be summarized as follows: Petitioner is a public utility engaged in the business of generation, transmission, distribution and sale of electricity in Oregon, Wyoming, Washington, California, Montana, and Idaho. During the years in issue (1962-1966), petitioner was regulated by the Federal Power

Commission (now Federal Energy Regulatory Commission) and the state public utility commissions in the states where it operated. It also engaged during these years in the construction of new transmission and distribution facilities in order to meet the increasing demands for electric energy in its service area. In constructing these facilities itself, petitioner used various transportation vehicles (automobiles, trucks, trailers) and power equipment, which it depreciated for book and tax purposes. For general financial accounting purposes, petitioner, in accordance with the accounting rules of the federal and state regulatory agencies, used the straight-line method of depreciation with respect to these items of equipment. The useful lives of the equipment were determined by empirical studies performed by outside consultants reviewing petitioner's own experience with the equipment. The Federal Energy Regulatory Commission required petitioner to capitalize the cost of depreciation on equipment used in the construction of capital facilities as part of the overall cost of a self-constructed asset (CR 21 at 5-6, 7-8). For federal income tax purposes, petitioner used the double-declining balance method of depreciation,[2] and determined the useful lives of the equipment under the class-life system[3] (Pet. App. B at 1-3).

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[1]"CR" references are to the docket control numbers assigned to the documents comprising the original record on appeal.

[2]Section 167(b)(2) of the Internal Revenue Code of 1954 permits a taxpayer to use a rate of depreciation not greater than twice the rate under the straight-line method. This method is known as the double-declining balance method.

[3]Section 167(m) of the Code authorizes the Commissioner to establish useful lives for classes of property in a particular industry or group. A taxpayer is allowed to compute its depreciation deduction based on these class lives rather than with reference to the useful life of any particular asset.

On its federal corporate income tax returns for the years in issue, petitioner deducted the total accelerated depreciation computed for the transportation and power equipment, including the amount allocable to the equipment's use in the construction of its own facilities.[4] On audit, the Commissioner of Internal Revenue determined deficiencies on the basis that all the depreciation claimed by petitioner that was allocable to the construction of its own assets had to be capitalized and not currently deducted. Petitioner paid the deficiencies and thereafter brought this refund suit in the United States District Court for the District of Oregon (Pet. App. B at 3-4). The district court upheld the Commissioner's assessments on the authority of this Court's decision in *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974), which presented a nearly identical factual situation (Pet. App. B at 5-7). The district court further held that "all of the depreciation expenses claimed [by petitioner] for tax purposes for equipment allocable to its use in the self-construction of longer-lived assets must be capitalized for tax purposes into the cost of the capital improvement regardless of the method of depreciation or useful life used for book purposes" (Pet. App. B at 8). The court of appeals affirmed (Pet. App. A).

1. The court of appeals correctly held that petitioner, with respect to self-constructed assets, must capitalize, as part of the basis of those assets, the entire amount of the depreciation taken on the equipment allocable to the construction of the assets. Petitioner argues (Pet. 12-13) that only the amount of straight-line depreciation need be capitalized, and that it is entitled to deduct currently the excess

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[4]The parties are in agreement concerning the proper allocation of petitioner's total depreciation deduction with respect to the transportation and power equipment between the equipment's use in the construction and in the operation and maintenance of petitioner's facilities (CR 21 at 5-6).

of double-declining balance over straight-line depreciation. The courts below, however, concluded that this Court's decision in *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1 (1974), requires petitioner to capitalize *all* the depreciation taken on its income tax returns with respect to such equipment and allocable to construction.

Contrary to petitioner's argument (Pet. 14-17), *Idaho Power Co.* controls the instant case. The facts of *Idaho Power Co.* are, in all material respects, indistinguishable. Like petitioner, the taxpayer in *Idaho Power Co.* was a regulated public utility that used a variety of transportation and power equipment to construct its own transmission and distribution facilities. It agreed with the Commissioner as to the allocation between the equipment's use in construction and operation and maintenance. The company was also required by federal and state regulatory agencies to capitalize the construction-related depreciation costs for book or financial reporting purposes. The equipment was depreciated on the basis of "a composite life of 10 years and under straight-line *and declining balance methods*" (418 U.S. at 5; emphasis added). Moreover, as here, the taxpayer claimed that all depreciation on the equipment could be deducted currently under Section 167(a)[5] of the Code, while the Commissioner argued that the depreciation on the equipment was a nondeductible capital expenditure. The

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[5]Section 167(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides as follows:

SEC. 167. DEPRECIATION.

(a) *General Rule*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

Commissioner therefore took the identical position advanced here, *i.e.*, that the depreciation on the construction equipment had to be added to the cost basis of the newly constructed facility and depreciated over that facility's useful life. 418 U.S. at 5-6.

This Court upheld the Commissioner, observing that the Commissioner's position was supported by accepted accounting practice and established tax principles. In so holding, the Court relied on Section 263(a)(1) of the Code, which prohibits current deductions for capital expenditures,[6] and the priority-ordering directives of Section 161[7] and 261[8] of the Code (26 U.S.C.), which require that the capitalization provision of Section 263(a) take precedence.

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[6]Section 263(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.), provides as follows:

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.* No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. * * *

[7]Section 161, Internal Revenue Code of 1954 (26 U.S.C.), provides:

SEC. 161. ALLOWANCE OF DEDUCTIONS.

In computing taxable income under section 63(a), there shall be allowed as deductions the items specified in this part, *subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible).* [Emphasis added.]

[8]Section 261, Internal Revenue Code of 1954 (26 U.S.C.), provides:

SEC. 261. GENERAL RULE FOR DISALLOWANCE OF DEDUCTIONS.

In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

The courts below correctly concluded that there was no basis for petitioner's argument that *Idaho Power Co.* is distinguishable because it involved only straight-line depreciation while this case involves the double-declining balance method of depreciation. As we have pointed out (*supra*, pages 4, 5), the taxpayer in *Idaho Power Co.* also used the declining balance method of depreciation with respect to some of the equipment used in its self-construction program. Indeed, the opinion of the court of appeals in *Idaho Power Co.* (477 F. 2d 688 (9th Cir. 1973)) emphasized the accelerated depreciation aspect of the case. It reversed the Tax Court, which had held that *all* depreciation had to be capitalized, and, in so ruling, expressed the view that the result reached by the Tax Court was contrary to the congressional policy to liberalize the depreciation allowance by means of accelerated depreciation methods (see 477 F. 2d at 692-693). This Court disagreed, stating (418 U.S. at 18-19; emphasis added):

> To be sure, the 1954 Code provided for new and accelerated methods for depreciation, resulting in the greater depreciation deductions currently available. These changes, however, relate primarily to computation of depreciation. *Congress certainly did not intend that provisions for accelerated depreciation should be construed* as enlarging the class of depreciable assets to which §167(a) has application or *as lessening the reach of §263(a).* See Note, 1973 Duke L.J. 1386.

Thus, a fair reading of *Idaho Power Co.* requires the conclusion that no current deduction is permissible under Section 167(a) for depreciation costs with respect to equipment allocable to the construction of capital facilities, regardless of the method of depreciation utilized for such equipment.

2. Contrary to petitioner's further argument (Pet. 17-25), even if the holding of *Idaho Power Co.* were to be viewed as leaving the question open, the reasoning of that opinion

would also support the result reached by the courts below. As the Court there stated (418 U.S. at 12): "Accepted accounting practice and established tax principles require the capitalization of the cost of acquiring a capital asset." The purpose of depreciation accounting is to distribute this cost over the accounting period benefited by the use of the asset, thereby matching income and expenses. 418 U.S. at 10-11. The only way that this objective can be achieved is by capitalizing all the depreciation claimed on equipment allocable to the self-construction of assets. Petitioner seeks to establish a hybrid method of depreciation accounting for such assets—a current deduction for the excess of accelerated over straight-line depreciation, and capitalization of straight-line depreciation. But the current deduction of any amount of depreciation on such assets creates a distortion of income, insofar as it will allow the current deduction of an expense related to the acquisition of capital assets, which is properly allocable to the production of future income. This conclusion follows from the fact that the method of depreciation affects only the computation and timing of the allocated cost of the asset so allocated. Straight-line and double-declining balance depreciation deal with the timing of the deductions taken with respect to such assets; accelerated depreciation merely allows more of a recovery of the cost in the early years of the depreciation period. There is, however, no difference in the two methods over the life of the asset. Thus the *cost* of depreciation on equipment allocable to the self-construction of assets must always be capitalized, regardless of the difference in exact timing of when this same cost is charged to expense under the straight-line or double-declining methods of depreciation.[9]

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[9]Petitioner therefore errs in arguing that the decision of the court of appeals is inconsistent with Section 1012 of the Code, which provides that the basis of property shall be its cost (Pet. 20-22). Simply stated, accelerated depreciation does not allow the allocation of amounts greater than cost over the useful life of an asset.

Moreover, the principle of tax parity (see 418 U.S. at 14) provides further support for the Commissioner's position. A taxpayer-public utility that purchased a transmission or distribution facility from an outside contractor would have to capitalize all the depreciation costs of the contractor, regardless of the method of depreciation used by that contractor. Thus, tax parity requires that the same result obtain here with respect to a taxpayer-public utility engaged in the self-construction of such capital facilities.

Lastly, petitioner's case is not supported, as it asserts (Pet. 24-25), by the provisions of other Code sections and Treasury Regulations dealing with manufacturers' inventories (Treasury Regulations on Income Tax, Section 1.471-11(c) (26 C.F.R.)), and construction contracts (Treasury Regulations on Income Tax, Section 1.451-3(d)(5) (26 C.F.R.)). These provisions have nothing at all to do with the decision in *Idaho Power Co.* and the clear directive of Section 263. The Commissioner has permitted manufacturers in computing their inventory cost to exclude the excess, if any, of accelerated depreciation over the depreciation given in their financial reports (which may or may not be accelerated depreciation) as an administrative convenience to the manufacturers. Section 471 of the Internal Revenue Code of 1954 (26 U.S.C.) requires the Commissioner to prescribe inventory rules "*as nearly as may be* to the best accounting practice in the trade or business [emphasis added]." The Commissioner has apparently made the determination that practical necessities require only the inclusion of financial accounting depreciation in inventory cost under the method of inventory accounting selected by manufacturers. This also explains why the Commissioner, in Section 1.451-3(d)(5) of the Treasury

Regulations, has not required a contractor in computing its cost under the completed contract method to include the excess, if any, of accelerated depreciation over that used in its financial reports.[10]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

SEPTEMBER 1981

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[10]Petitioner seems to suggest (Pet. 20 n.5) that it should capitalize only the straight-line portion of the depreciation taken on its equipment allocable to the construction of its capital facilities because that is in accordance with the depreciation accounting rules of the Federal Energy Regulatory Commission. In *Idaho Power Co.*, however, the Court recognized that the accounting practices of federal regulatory agencies have never been considered as necessarily controlling the proper accounting practices for income tax purposes. 418 U.S. at 15; accord, *World Airways, Inc.* v. *Commissioner*, 62 T.C. 786, 798-801 (1974), aff'd, 564 F. 2d 886 (9th Cir. 1977) (Civil Aeronautics Board accounting); *Gulf Power Co.* v. *Commissioner*, 10 T.C. 852 (1948) (Federal Power Commission accounting). Even if petitioner's method is in accord with the federal regulatory agency's accounting procedure, such a financial accounting practice cannot prevail over a determination by the Commissioner that the applicable tax laws require the capitalization of depreciation expenses such as those here in issue, a determination which must stand for tax purposes, unless the Commissioner has acted arbitrarily. See *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 532-533 (1979). The Commissioner's position here is clearly not arbitrary. Not only is his interpretation supported by the binding precedent of *Idaho Power Co.*, but it is the only one in accord with tax depreciation principles.

Petitioner's Reply Brief

Office - Supreme Court, U.S.
FILED
SEP 28 1981
ALEXANDER L. STEVAS
CLERK

No. 81-278

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

PACIFIC POWER & LIGHT COMPANY,

Petitioner

v.

UNITED STATES OF AMERICA,

Respondent

PETITIONER'S REPLY BRIEF

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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

No. 81-278

PACIFIC POWER & LIGHT COMPANY,

Petitioner[1]

v.

UNITED STATES OF AMERICA,

Respondent

PETITIONER'S REPLY BRIEF

In its Memorandum in Opposition, respondent has raised the argument that Commissioner v. Idaho Power Company, 418 U.S. 1 (1974), "controls the instant case." Memorandum of United States in Opposition at 4. As its support for this proposition, respondent notes that the taxpayer

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1. For a list of petitioner's parent companies, affiliates, or subsidiaries, see Petition for Certiorari at 5.

in Idaho Power, like petitioner, took accelerated depreciation deductions with respect to its construction related equipment. Since this Court's decision resulted in capitalization of all such deductions, respondent argues, Idaho Power precludes petitioner's arguments on the merits of this case.

Petitioner concedes that the taxpayer in Idaho Power may in fact have taken accelerated depreciation deductions (although the degree of acceleration may have been insignificant), and that the Court's decision resulted in all such deductions being capitalized. Nonetheless, the Court in Idaho Power never ruled on the issue raised by petitioner ir this case. In Idaho Power, the parties stipulated the amount to be capitalized if respondent prevailed; the issue was whether any depreciation had to be capitalized. 418 U.S. at 3 ("sole issue"). Thus,

respondent's assertion that Idaho Power controls this case merely because its facts were similar cannot be sustained. "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents." Webster v. Fall, 266 U.S. 507, 511 (1925), citing cases.

The Memorandum in Opposition also misreads the Court of Appeals' opinion in Idaho Power. While that opinion acknowledged that accelerated depreciation is limited by Section 263(a) of the Code, it did not expand Section 263(a) to require capitalization of amounts that do not constitute a cost incurred. The measure of depreciation was simply not an issue.

Respondent's unwarranted leap of logic prevailed in the Court of Appeals in this case. The reasoning

behind the judgment here illustrates confusion in the lower courts concerning the true meaning of Idaho Power. If the mistaken reading urged by respondent is perpetuated, the important question whether all tax depreciation must be capitalized may never be answered, or even asked.

Respectfully submitted,

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